

"Give Me Chastity ... But Not Yet"

Russia's Great Macroeconomic Transition

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A LESSON FOR 21ST-CENTURY RUSSIA FROM 4TH-CENTURY ST. AUGUSTINE

History buffs will certainly recognise the famous quotation from St. Augustine, who, despite profoundly influencing Western Christianity in the 4th century and beyond by preaching a closer association with God, found his youth so full of temptations that he wanted to enjoy them as long as possible before finally becoming a committed follower of God's commandments. This has an eerie similarity with Russia today, as the country is facing a dramatic change in its economic paradigm over the next couple of years – one that will determine its future economic development. The inevitable transition from twin (fiscal and current account) surpluses to twin deficits that will be completed by 2014, on our estimates, will be the most important thing to watch. Will Russia continue to dither in addressing the imminent twin deficits? Or will it, in recognising their far-reaching macroeconomic implications, strive to improve its investment climate in order to finance these deficits? We are modestly optimistic.

THE GREAT TRANSITION

With fears of a new global recession looming, investors have been pre-occupied with managing their asset positions. Russia has not been spared the wrath of money managers, as the stock and fixed-income markets have exhibited heightened volatility. These cyclical developments are of course important to watch, but they mask a much bigger structural issue that needs to be well understood – and in fact to stay centre-stage for anybody that has even a perfunctory interest in Russia.

"Twin surpluses were the name of the game, pre-crisis. The 2008 financial crisis led to a sharp fiscal reversal."

Significant twin surpluses were the name of the game pre-2009, as solid economic performance and constantly rising oil prices ensured comfortably full state coffers and sizeable current account surpluses. Federal surpluses were running at 7% of GDP, while the current account surplus did not decline even during the 2008 financial crisis. However, the new post-crisis normal is

now starting to turn the tables gradually on the current account – and even more so on the fiscal balance.

Due to its prudent fiscal stance in the upswing, underpinned by saving a significant portion of the oil windfall, Russia looked much better placed than many other EM economies to endure the 2009 crisis by (correctly) pursuing an aggressive countercyclical policy in the downswing. Consequently, while cushioning the adverse impact of the crisis on growth, the 10% of GDP turnaround in the fiscal position led to a significant fiscal deficit – of 5.9% of GDP in 2009 (from a surplus of 4.1% of GDP in 2008). While the headline numbers have improved over the past two years, the government still forecasts continuing fiscal deficits well into 2014 – even at oil prices as high as \$100/bl.

Things look even gloomier if one excludes the effect of oil revenue on the fiscal position. While higher oil revenues create more fiscal room for spending, they also complicate macroeconomic management and foster dependence on a volatile and uncertain source of income. Therefore, a better measure to gauge the true stance of the public finances is to compute the non-oil deficit, which corrects the headline number for the state of the economic cycle and oil revenues.

We estimate that the non-oil deficit has expanded progressively from an approximately balanced position at the turn of the century to -12.5% of GDP in 2010. We estimate that it will only fall to -10.5% of GDP in 2011 and -9.0% of GDP in 2014. This leaves it at about twice the level (-4.7% of GDP) that is consistent with keeping the country's oil wealth constant over time. This is also the government's own recommended target – one that had been enshrined in the budget law but removed in late 2008, to allow for accelerated anti-crisis spending. The authorities have indicated their intention of making the -4.7% of GDP non-oil target binding again, although no clear decision has been taken yet.

"The current account surplus will disappear by 2014, we estimate, even with an oil price of \$100/bl. This could make the economy increasingly vulnerable to fickle capital account flows."

The current account is still registering surpluses, although the very nature and structure of trade argue convincingly that this situation is unsustainable. With the better part of exports centred on oil – the extraction of which has been broadly constant over the past couple of years – and an increasing import bill, deriving from a growing economy, the current account balance is set to shrink over time, and ultimately move into deficit.

This process is fully under way, as evident from the declining current account surplus, and this is despite the very favourable evolution of commodity prices over the past decade. We estimate that the current account will break into negative territory in 2014 with oil at \$100/bbl and in 2013 with oil at \$90/bbl. Russia will thus complete the uncomfortable transition from twin surpluses to twin deficits in just a couple of years' time.

The disappearance of the current account surplus could make the economy increasingly vulnerable to fickle capital account flows. Net capital outflows will hit about \$70bn in 2011. Their magnitude, as a share of GDP, is much smaller than the peaks reached during 2008-2009 and 1998-2001, and they are still comfortably outweighed by positive flows on the current account. However, flows on the capital account (assuming they remain negative) will start to bite in a much more pronounced fashion when the current account surplus disappears by 2014E.

A BINARY OUTCOME

Living with twin deficits will present a new set of challenges for Russia, as it will need to find ways to finance these gaps. Despite low public and external sovereign indebtedness, persistent external and public deficits – the latter of which will be exacerbated by rising health and pension obligations – will require a revised approach to attracting foreign investment, including foreign direct investment (FDI), portfolio flows and external credits.

“The prospect of twin deficits poses an acute dilemma.”

Financing these deficits will thus be a key challenge for Russia, in particular in the light of the unfavourable business environment. The perennial issue of rampant corruption continues to affect investor perception about the country. The 2010 Corruption Perceptions Index published by Transparency International does not exactly lend a helping hand to Russia, either. Its transparency rating fell from 2.2 to 2.1 on a scale of 0.0 (highly corrupt) to 10.0 (very clean), which was enough to rank Russia 154th out of 178 countries, between Papua New Guinea and Tajikistan.

Other alleged business-unfriendly practices, including stifling business regulations, a perceived lack of the rule of law and insufficient protection of minority rights, have also weighed on investors' minds, while an unending supply of headline stories about government corporate abuse have contributed to the overall view that Russia is losing against other EM economies in the global competition to attract foreign investment.

We, however, are more optimistic, as we think that the Kremlin may be starting to at least recognise the graveness of the issue. We think the authorities are gradually starting to warm up to the realisation that, in a global environment increasingly characterised by more subdued G10 growth, the prospects for oil price increases post-crisis that are similar to those pre-crisis are rather limited.

Consequently, with the current account expected to move into a deficit position over the medium term, and a large structural fiscal deficit, it is imperative for Russia to improve the business climate in order to attract the requisite capital inflows to finance these deficits. Guessing the Russian authorities' intentions is a dangerous game, but in our view the crisis has brought about a new frame of mind that is more open and welcoming to foreigners.

Some tentative signs are already visible, as the government has started a new privatisation programme (admittedly slightly delayed now due to the unfriendly global backdrop), increased the list of the strategic enterprises open to foreign investment, made important steps towards moving Russia closer to

WTO membership and accelerated the process of making the domestic bond market Euroclearable. These reforms are, in our view, underappreciated and underpriced.

“Some tentative signs of the right approach to tackle the impending twin deficits are already visible.”

“The right approach now will ensure less volatile economic performance post-crisis.”

At the same time they will be implemented only in an evolutionary manner, and it would be remiss to assume that any changes – positive or negative – will happen quickly. Rather, we think it much more realistic to assume they will proceed only cautiously. Therefore, although one should be careful when trying to extrapolate from only a few indicators, we think the current reform agenda has more significant underlying momentum than at first appears.

Moreover, the timing of these initiatives is, curiously, coinciding with an overall feeling that Russia is finally waking up to the fact that the world is now much less conducive to an introverted standpoint. We think the less favourable external backdrop and the need to invest heavily in its decrepit infrastructure is inviting a fresh look at the problem that has plagued Russia for centuries: how to create a dynamic economy, firmly grounded in innovative thinking, with higher rates of capital accumulation and healthy productivity growth. We are cautiously optimistic.